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Supreme Court of the United States

OCTOBER TERM, 1947

Nos. 184-9

IN THE MATTER

of

THE CHICAGO, ROCK ISLAND & PACIFIC RAILWAY COMPANY,

Debtor.

THE CHICAGO, ROCK ISLAND & PACIFIC RAILWAY COMPANY,

Debtor-Petitioner,

v.

METROPOLITAN LIFE INSURANCE COMPANY, as remaining member of the First and Refunding Group, CENTRAL HANOVER BANK AND TRUST COMPANY, *et al.*, as Trustees, THE NATIONAL CITY BANK OF NEW YORK, as Trustee, J. HAMILTON CHESTON, *et al.*, JOHN C. TRAPHAGEN, *et al.*, JAMES G. BLAINE, *et al.*,

Respondents.

MEMORANDUM OF RESPONDENTS AS TO SO-CALLED "REPLY BRIEF" OF THE DEBTOR.

On September 17, 1947 (over a month following the filing by respondents of their answer to Debtor's petition for certiorari), the respondents received a brief of the Debtor which it designates as a "Reply Brief" but which seeks to put before this Court new material, having no legitimate bearing on the merits of the present case, which

respondents have heretofore had no opportunity to discuss or answer. The "Reply Brief" also contains incorrect and fallacious statements with regard to such material. Respondents therefore submit this memorandum to refute the contentions made in the "Reply Brief".

1. The Debtor states erroneously (p. 6) that the Interstate Commerce Commission's recommendation that the Missouri Pacific plan be referred back to it was based on a "change of economic conditions" and that it indicated "the Commission's attitude toward present plans". The Commission's memorandum was not of general application but was expressly based on a unique combination of circumstances existing only in the Missouri Pacific case.

It is extraordinary for the Debtor to go outside the record of the present case and submit to this Court a memorandum of the Interstate Commerce Commission in another case which is based on the special facts of that case and which is expressly applicable only to those facts.

That the *Missouri Pacific* situation is unique is demonstrated by the fact that all parties appearing in that proceeding, long before the Commission filed its memorandum, had taken the position that the plan in that case (which had been approved by the District Court but not confirmed) should be remanded to the Interstate Commerce Commission, and the further fact that, when the proceeding recently came before the Circuit Court of Appeals for the Eighth Circuit on appeals from the approved plan, no party appeared in support of the plan but all the parties (appellees as well as appellants) requested the Court to remand the matter to the Commission. In contrast with this, all the secured creditors appearing before the Circuit Court of Appeals for the Seventh Circuit in the *Rock Island*

case joined in asking the Circuit Court of Appeals to direct confirmation of the plan, and only representatives of unsecured creditors and of the stock opposed confirmation of the plan.

The Commission's memorandum in the *Missouri Pacific* case (Appendix B to the Debtor's reply brief) shows that the recommendation therein made was largely based (a) on the enormous payments (not in amounts allotted in the Missouri Pacific plan) which had been made to Missouri Pacific creditors after the Commission's consideration of the plan, particularly when considered in the light of the provisions of the District Court orders under which the payments were made, and (b) on unusual provisions of the Missouri Pacific plan which do not appear in the Rock Island plan.

As to (a),—In the *Missouri Pacific* case a total of over $114,000,000 in principal and interest was distributed, after January 1, 1943 (the effective date of the Missouri Pacific plan), to Missouri Pacific creditors, and this included the retirement of more than $55,000,000 of Missouri Pacific senior debt. The District Court orders under which a substantial part of these obligations was retired provided that the Missouri Pacific Trustees should hold such obligations *for the benefit of the remaining creditors to the extent of their respective interests in the cash used for such retirement.* As a basis for recommending that the Missouri Pacific plan be remanded to it, the Commission expressly pointed out in its memorandum that it was doubtful that the Missouri Pacific plan contemplated that claims should be so acquired for the benefit of other classes of creditors, and further said:

> "The working out of a fair and equitable adjustment of the distribution of cash and securities will

> be a complicated matter. To attempt to do this within the framework of the present plan may result in substantial disturbance of the balanced relationship of the treatment provided for the various classes of creditors."

No such problem arises in the *Rock Island* case under the provisions of the Rock Island plan as applied to payments to creditors made in that case.

The only substantial claim of a Rock Island creditor which has been paid off since approval of the plan by the Interstate Commerce Commission is the claim of Reconstruction Finance Corporation in the amount of about $17,000,000. That claim was paid *before* approval of the plan by the District Court in June, 1945 and the vote of creditors; and in its opinion of May, 1945, expressing approval of the plan, the District Court emphatically ruled that the payment required no change in the plan but that, as provided in the plan, the securities allotted to Reconstruction Finance Corporation should not be redistributed but should be held in the Rock Island treasury. The District Court said (67 F. Supp., at p. 553):

> "The court considers the payment of the claim of the Reconstruction Finance Corporation, or the payment or purchase of other claims or bonds, if any be ordered, to be consistent with the plan and to afford no basis for any redistribution of securities which would involve a modification of the plan.***
>
> * * * * * *
>
> "The use of the money will not constitute a change in conditions calling for a modification of the plan. The money has accumulated, and there is no basis for saying that there is more in the estate than was expected when the Commission approved the plan. The use of the money to retire debt does not change the

situation any more materially than would the use of it for additions and betterments or the accumulation of it for future use."

The views of the District Court on this point were substantially similar to those later advanced by this Court in rejecting the contention that payments, under District Court orders, of certain claims in the *Denver & Rio Grande Western* reorganization proceeding required reconsideration of that plan by the Commission (328 U. S. 495).

The only other large cash payment to creditors in the Rock Island proceeding since approval of the plan by the Commission was the payment in 1945 of approximately $34,000,000 to the various creditors *in the precise amounts of the cash allotted in the plan* as approved by the Interstate Commerce Commission and the District Court. The Trustees of the Rock Island estate had advised the Interstate Commerce Commission that that amount would be available for distribution to creditors as of January 1, 1944; the Commission and the District Court had accordingly approved the plan allotting that amount of cash to the various creditors; and obviously distribution of that exact amount of available cash was not a change of conditions but, on the contrary, was expressly contemplated by the approved plan.*

No accounting proceedings with regard to redistribution of securities or cash are necessary in the *Rock Island* case under the terms of the Rock Island plan and of the District Court orders in that case, as compared with the further complicated proceedings which the Commission emphasized would be necessary in the *Missouri Pacific* case.

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* Between $2,000,000 and $3,000,000 has also been distributed in the Rock Island proceeding to holders of terminal facility bonds and of Choctaw & Memphis Bonds. The position of these creditors was not disturbed by the plan so that such distribution represents no change in the dispositions made by the plan.

As to (b),—The Missouri Pacific plan also contained a series of unusual provisions, *not* present in the Rock Island plan, which the Commission said it wished further to consider.

The Missouri Pacific plan provided that senior creditors allotted new securities in the plan would have the right to elect to accept cash in compromise of their claims in amounts representing only a fraction of the claims. This percentage varied from 29% to 62%. These provisions were inserted in the plan in order to make new securities available for the most junior claimants. However, if these cash options were not eventually exercised by creditors, the new securities would not be available for those junior claimants without increasing the capitalization over the maximum amount permitted by the Commission. Accordingly, the plan provided that to the extent that creditors did not eventually elect to take the cash options, the reorganization managers should use the cash so made available to purchase new securities in the market with a maximum price for new General Mortgage Bonds of 62 and for new common stock of 26. In its memorandum, the Commission said that these cash option provisions should be reviewed to determine whether they are practicable under present conditions of the security market, and that various questions, which were not covered by the plan, should also be resolved with respect to the purchase by reorganization managers of new securities. There are no similar provisions in the Rock Island plan so that no such problem arises in the Rock Island proceeding.

In the light of the facts of the *Rock Island* case as contrasted with those of the *Missouri Pacific* case, we submit that it is clear that the Commission's recommendation in the Missouri Pacific proceeding has no bearing whatever in the Rock Island proceeding.

As shown in respondent's answering brief already on file (pp. 29-32), there is no excess cash in the Rock Island treasury, but all the cash in the treasury is needed for railroad purposes, including the servicing of the new securities issuable under the reorganization plan. The "available" cash would be used up if a dividend of only $3.50 per annum, for the period since the effective date, were paid on the new common stock issuable under the plan. Furthermore, since the end of hostilities, Rock Island earnings have not been more than enough to service the new securities currently, including a moderate dividend on the new common stock (See Point 3(b) below). In view of the above circumstances, there would be no basis whatever for the Commission's revising the Rock Island plan.* We submit that the Rock Island plan should be carried out just as the Denver & Rio Grande Western plan was carried out earlier this year, and as the New York, New Haven & Hartford plan has now been carried out. The consummation order in the latter case was entered by the District Court on September 11, 1947, this Court having denied applications for certiorari to review the New Haven plan on June 23, 1947 (67 S. Ct. 1754, 1755).

2. The memorandum of four members of Congress which is relied on by the Debtor has no bearing on the issues in this proceeding.

The Debtor attaches to its "Reply Brief", as Appendix A, a statement, dated August 1, 1947, by four Federal

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* The District Court sent the plan back to the Commission with directions to revise it. The Commission, in its discretion, took no action pending appeal from the District Court order, which order was thereafter reversed by the Circuit Court of Appeals. There is nothing in the Commission's determination to await the outcome of the appeal which supports the Debtor's contentions in any way.

legislators supporting further delay in carrying out Section 77 reorganizations on the ground that new legislation may be enacted. The following statement of this Court in the *Denver & Rio Grande Western* case (328 U. S. 495, at pp. 509-12) would seem to be a complete answer to the effort further to prolong this fourteen-year-old reorganization for the purpose of awaiting possible legislation:

> "In examining the contentions of petitioners as to the alleged errors of the Circuit Court of Appeals, we must approach the problems in accordance with our reviewing authority under §77. That section embodies the method that Congress selected in 1933 and improved in 1935 to put the railroad transportation system of the country in order to meet its debts and perform its duties to the public after the hard years of the recent depression. Our constructions of the chief provisions of the section were handed down in March, 1943. Although the results of reorganizations under the section, as thus construed, have been criticized as unfortunate and changes have been suggested, no different legislation has been enacted. Indeed a different method for reorganization, enacted in 1939 and designed to meet the requirements of railroads not in need of financial reorganization of the character provided by §77 but only of an opportunity for voluntary adjustments with their creditors, terminated on July 31, 1940, and a comparable provision made in 1942 was allowed to lapse on November 1, 1945. This situation leaves clear the duty of the agencies of the Government entrusted with the handling of reorganizations under §77, including this Court, to administer its provisions according to their best understanding of the purposes of Congress as expressed in the words of §77 read in the light of the contemporaneous discussion in Congress. Changes in economic conditions cannot affect the powers of the reorganization

> agencies even though such changes may require a reexamination into the present fairness of the former exercise of those powers." [Footnotes omitted.]

It would seem that the following statement in the Debtor's "reply brief" (p. 5) is also directly inconsistent with its contention:

> "It is obvious that the courts cannot wait for possible legislative changes in reorganization proceedings any more than in other types of cases."

Proposals for amendment of Section 77 have been put forward since 1943, and a number of such proposals are referred to in the footnotes to the above extract from this Court's opinion in the *Denver & Rio Grande Western* case. For several years efforts have been continuously made to delay Section 77 reorganizations on account of the possibility of legislation amending or superseding Section 77. We submit that the present state of affairs is that there already has been too much delay rather than that further delay is warranted.

Furthermore, there is a pronounced difference of opinion in Congress with respect to this proposed legislation. There were vigorous dissenting reports in the legislative committees.

The dissent in the Senate Committee on Interstate and Foreign Commerce, joined in by six Senators, severely condemned the proposed legislation (Report 432, Part 2, to accompany S. 249, 80th Congress, 1st Session).

The dissent in the House Judiciary Committee was signed by eleven members of the Committee and concluded as follows (Report 923, Part 2, to accompany H. R. 3980, 80th Congress, 1st Session, p. 8):

> "The enactment of this bill would be so harmful to the public interest, so injurious to railroad credit,

and so inequitable in its results that the Congress should reject it."

The Interstate Commerce Commission has also placed itself on record as strongly opposed to the proposed legislation. In a letter, dated May 12, 1947, to the Chairman of the Sub-Committee on Bankruptcy and Reorganization of the House of Representatives (Hearings on H. R. 3237, 80th Cong., 1st Session, Serial No. 6, pp. 168-180), the legislative committee of the Commission (composed of members of the Commission) stated the reasons why the Commission thought the legislation should not be enacted, and summarized its objections as follows:

"It is our view that H. R. 3237, because of the provisions of section 2, will not accomplish its purposes and is fundamentally unsound for the following reasons:

"1. It discards some plans of reorganization carefully worked out over a number of years by creditors of the railroads, approved with certain modifications by the Commission and the district courts after painstaking study and thorough consideration, accepted by more than two-thirds in amount of the total claims found to be entitled to participate in the reorganization, confirmed by the district courts, and now ready for the final steps required to complete reorganization.

"2. It suspends and discontinues the proceedings under section 77, leaves the properties in the custody of the courts, removes the trustees, and puts the debtors in possession of the properties, regardless of whether under any reasonable test the debtors have any equities in the properties.

"3. The provisions of section 1 were intended for application to solvent railroads and are unsuited

and inadequate for working out plans of adjustment for railroads in process of reorganization under section 77.

"4. It would impede rather than hasten readjustment of capital structures, would suspend indefinitely the rights of creditors, and would result in great waste of time, effort, and money.

"5. It would, in adjustments made pursuant thereto, require sacrifices on the part of creditors for the benefit of stockholders without any sacrifice on the part of stockholders, and continue in effect, contrary to the public interest, capital structures which cannot survive in a period of decreasing earnings and increasing costs.

"6. It would damage rather than restore credit of the railroads of the country as a whole.

"7. It is unworkable.

"8. It is unnecessary since any inequities resulting from the provisions of section 77 of the Bankruptcy Act can be remedied by a simple amendment of that section."

The statement of the four legislators regarding the "injustice and inequity of rushing the innocent security-holders of these railroads 'to the guillotine'" wholly ignores the fact shown by testimony before the legislative Committees that 80% to 90% (or more) of the stock owned at the commencement of the Rock Island bankruptcy proceeding in 1933 has since been sold at nominal prices to speculators (Hearings on H. R. 3237, 80th Cong., 1st Session, Serial No. 6, pp. 153-4; Minority Report, No. 923, Part 2, to accompany H. R. 3980, 80th Congress, 1st Session, p. 3). During this whole period, these stocks have been selling at nominal prices. As to the persons who bought stock of a bankrupt railroad at nominal prices and

then proceeded to press for legislation which they could turn to their profit, it would hardly seem that they are entitled to protection of their speculative investment at the expense of holders of mortgage bonds which have been in default for 14 years.

Furthermore, it is simply impossible to legislate value into a situation where the value does not exist. About $140,000,000 of unpaid accrued interest has accumulated in the Rock Island bankruptcy since the original defaults in 1933, and this must be given recognition ahead of the stock. Even the District Court's opinion on which the Debtor relies had this to say (R. 253):

> "The Commission cannot throw to the winds all consideration of future earnings, nor can it perform miracles. The war revenues are past, higher costs of labor and materials, and many other new problems beset railroad management. With the most optimistic approach by the Commission it would be vain for the junior creditors to expect to be made whole."

If the junior creditors could not expect to be made whole, it is inevitable that nothing remains for the old stock.

3. There are additional incorrect and fallacious statements in the Debtor's "reply brief".

(a) The Debtor says (p. 2) that the plan was rejected by "two important classes of creditors".

The fact is that all the secured creditors overwhelmingly voted to accept the plan except one small mortgage on 22 miles of line which was held by the Commission to have a claim against the Rock Island system in the principal amount of only $453,600. Representatives of that issue did not oppose confirmation of the plan.

The unsecured Convertible Bondholders were the only other class rejecting the plan, and they necessarily had only a meager claim. Under the plan, secured creditors have a total deficiency not recognized in any new securities of $106,000,000. It follows that little was left for the unsecured creditors and that they were therefore dissatisfied with their allotment of approximately 5 shares of new common stock and $12.42 in cash for each $1,000 bond. But creditors in a similar position in the *Denver & Rio Grande Western* case were likewise dissatisfied and voted against the plan which, nevertheless, was confirmed and carried out.

(b) The Debtor is incorrect when it says (p. 2) that the District Court found the rejection justified because of "a large and unanticipated increase in the earnings of the debtor *after the plan had been approved*" (italics in original).

The District Court made no such statement either in its opinion or in its order (R. 249-255). It could have made no such statement in view of the fact that the trend of earnings has been steadily downward for each calendar year since the plan was approved by the Commission. In 1943, before the modified plan was approved by the Commission, the earnings before interest were $37,037,708,—whereas for the year 1944, during which the modified plan was approved by the Commission, the earnings declined to $26,415,919. During 1945, when the plan was approved by the District Court, the earnings declined further to $20,444,571; and thereafter in 1946 the earnings declined again to $16,578,161.

The Debtor quotes (p. 3) from the *Denver & Rio Grande Western* decision of this Court to the effect that rejection of a plan might be justified if unanticipated, large earnings developed after approval of the plan. But in the

Rock Island case earnings were much lower in 1946 when the creditors voted on the plan than they were in 1944 and 1945 when the plan was approved, and therefore the *Denver & Rio Grande Western* decision is squarely opposed to the Debtor's contention.

The current earnings of the Rock Island are moderate in relation to the new capitalization provided in the plan. The $16,578,161 of earnings available for interest in 1946, if applied to the capital structure set up in the plan, would leave a balance after dividends on the new preferred stock of about $7,500,000 or roughly $5 per share on the new common stock. Even if this total amount were paid out as a dividend on the new common stock (which most Rock Island creditors must take at $100 a share or more), it could hardly be considered as an unduly large annual dividend. And the fact, of course, is that neither the Rock Island nor any other railroad would pay out every last cent of available earnings as dividends on the common stock, but, in the normal course, would pay out only a percentage of such earnings. Earnings such as those of 1946, which produce from $2.50 to $5 a share as dividends on the new common stock, can surely not be considered as unexpectedly large. If some earnings had not been expected for the new common stock which is allotted to creditors for their claims, the Commission would not have included it in the new capitalization. In the light of these earnings, the new common stock is selling on a "when issued" basis at only about 26.

(c) The Debtor's brief says (p. 3) that the Commission based the plan on an earnings estimate of $11,000,000 and that current earnings are higher than this.

The Commission's reports and published schedules show that the amount of $11,000,000 was used only in determining the amount of new income bonds to be issued

in the reorganization. In addition to the new bonds, the Commission provided for $75,000,000 of new preferred stock and for $150,000,000 of new common stock (taking each share at $100). The $75,000,000 of preferred stock was allocated among creditors on an assumed earnings level of about $17,000,000 (252 I. C. C., at p. 499, line 1, col. 21).

On an earnings level of $11,000,000, no earnings or dividends would be available for the enormous new issue of common stock provided by the Commission, and obviously the Commission believed that there was reasonable assurance that there would be earnings and dividends for the common stock it was allotting to creditors.

Since the present earnings do no more than service the new capitalization, including a moderate dividend on the new common stock, it is plainly erroneous for the Debtor to contend that present earnings are more than those anticipated by the Commission when it set up this new capitalization.

(d) The computation which the Debtor (pp. 3-4) bases on earnings for the first 7 months of 1947 is also fallacious.

The fallacy is that the Debtor compares those earnings with the interest charges on the principal amount of the old debt, leaving entirely out of consideration that in 13 years no interest has been paid to secured creditors except for one distribution in 1945, and that, after applying that one distribution on accrued interest, the remaining unpaid accrued interest to date would amount to about $140,000,000. The Debtor has consistently sought to ignore this enormous accrued interest and to have the Debtor's rights determined as if this accrued interest had been paid, and it does so again in the computation now submitted. But the accrued interest has not been paid; it is ahead of stockholders' claims; it must be given recognition before stockholders

receive any recognition; it is only partially recognized in the present plan because there are not enough assets to recognize it in full; and a computation which ignores this vast amount of unpaid accrued interest is misleading and unworthy of consideration.

The earnings for the first seven months of 1947 have been at a slightly higher rate than those for 1946, but still, if earnings at that rate were to continue through the year 1947, they would not produce any extraordinary earnings or dividends for the new common stock and would be substantially below the levels of 1943 and 1944. However, it is well known that earnings for the first part of 1947 have not been normal for two reasons, one, because of the abnormally large movements of grain for export to Europe, and, two, because of the substantial increase in wages recently granted to non-operating employees and the substantial increase in wages expected to be granted to operating employees in the near future, which wage increases are in no way reflected in the earnings for the first part of 1947. These increases in wages will cause earnings sharply to decline in the remainder of 1947 and there is a certainty, at least, of a serious time lag between such wage increases and any rate increases which may be granted to offset them.

(e) The Debtor's arguments (pp. 7-9) that it has standing to apply for certiorari are unsound.

It should first be noted that in connection with the approval of the plan, the Debtor made no claim that there was any equity for stockholders and the Circuit Court of Appeals referred to this concession in affirming approval of the plan (157 F. (2d) 241, 245). In view of this concession by the Debtor, it has no standing in the subsequent confirmation proceedings which affect only creditors. The Section 77 cases now cited by the Debtor to show that other

debtors have been heard by this Court were cases where the debtor claimed there was an equity for its stock.

The Debtor's contention that it has a standing to apply for certiorari to review the order directing confirmation, notwithstanding that there is concededly no equity for the stock, is based on Section 77(c)(13) of the Bankruptcy Act from which the Debtor quotes only the provision that "the debtor" has the right to be heard in the proceeding. But that provision is that "the debtor, any creditor or stockholder," and other enumerated persons have the right to be heard. Certainly a stockholder or a creditor could not take an appeal from a decision relating to the rights of another party and not adversely affecting him, and the same must be true of the debtor. (*Cf. Missouri Pacific R. Co.* v. *Thompson,* 134 F. (2d) 139, C. C. A. 8, 1943.)

The very case upon which counsel for the Debtor relies, *In Re Keystone Realty Holding Co.,* 117 F. (2d) 1003, 1005 (C. C. A. 3, 1941), states, in referring generally to the right of appeal in Chapter X of the Bankruptcy Act, that under a similar provision of that Chapter creditors "adversely affected" have the right of appeal. The Debtor is not adversely affected by the allocation of securities among creditors when the Debtor has not claimed that there is an equity for the stock.

The lack of standing of the Debtor in the present situation is indicated by the following ruling of this Court in the *Denver & Rio Grande Western* case (328 U. S., at p. 520):

> "It would also follow that the objection of a stockholder, the Missouri Pacific Railroad Company, through its Trustee in reorganization, to a voting trust for future control of the debtor would be ineffective because this stockholder is eliminated from the reorganization by the valuation of the property and allocation of securities."

Conclusion.

The Debtor, consistently with the position it has taken for many years, seeks further delay in carrying through the plan in this 14-year-old reorganization proceeding. To support that effort, the Debtor presents a memorandum of the Interstate Commerce Commission filed in the *Missouri Pacific* case which has no application to the facts of the *Rock Island* case, presents a statement by four Federal legislators as to proposed legislation which adds nothing to what was before this Court in the *Denver & Rio Grande Western* case and was held by this Court not to warrant further delay, and presents misleading and fallacious computations as to the current earnings of the Rock Island, which ignore the $140,000,000 of unpaid accrued interest and the fact that the recent earnings are less than they were in 1943, 1944 and 1945 and are no more than are needed to service the new securities including a moderate dividend for the new common stock.

We submit that the additional material lends no support to the Debtor's petition for certiorari, and that the petition should be denied.

Respectfully submitted,

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September 23, 1947.